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The Growing Hryvnia: Reasons and Forecast

The National Bank's steps to make the hryvnia stronger in late April 2005 were brought about by the laws of the market. The ground for such an appreciation was laid by inflationary processes partly stimulated by a major forex influx from Ukrainian export operations and the general global trend towards a weaker US dollar—to which the hryvnia has been pegged for a long time. According to ICPS economists, the sudden approach chosen by the NBU was more appropriate than a gradual strengthening towards the UAH 5.10/USD 1 rate written into the 2005 State Budget. Indeed, there are signs that Ukraine could soon expect another jump in the exchange rate

The economy needed a stronger hryvnia

During the last four years, Ukraine has been showing a foreign trade and current account surplus. In other words, the volume of imported goods and services coming into the country over this period was less than the volume of exports leaving it. In 2004, the trade surplus stood at US $3.676bn, which was 5.6% of GDP. At US $6.838bn, the current account surplus was even higher, equivalent to 10.5% of GDP. This means that 10% of the country's economic output was not consumed but converted into foreign currency.

This foreign currency was purchased by the National Bank of Ukraine to artificially support the undervalued hryvnia. As a result, NBU forex reserves grew and there was an ongoing influx of hryvnia to the economy that exporters received in exchange for foreign currency purchased by the National Bank. However, this surplus hryvnia is not supported by a commensurate increase in consumer goods. A growing money mass without a related increase in output always leads to inflation.

An economy seeks balance. If the nominal exchange rate is maintained artificially, the economy adjusts the real exchange rate through a commensurate inflation-driven depreciation of the currency. Thus, it is possible to claim that the high 12.4% inflation in 2004 was, at least in part, the result of an undervalued hryvnia exchange rate against the US dollar after prices for metal products—the key source of export revenues—climbed sharply in 2003. The problem with importing inflation and an unbalanced exchange rate is not a phenomenon unique to Ukraine's economy. Russia and Kazakhstan also posted much higher inflation than had been projected, due to growing global oil prices.

Pegging to the US dollar, which has been allowed to depreciate steadily against the euro in recent years in order to somehow improve the US balance of payments, has led to growing inflationary trends. The World Bank in its 2005 Global Development Finance Report points to the fact that the shrinking of the US dollar against other global currencies is the most significant risk for developing economies, as they keep a considerable portion of their foreign currency reserves in dollar-denominated liabilities. At the same time, the value of the dollar measured in the majority of global currencies—including the currencies of all FSU and CEE countries—has been declining steadily over the past two years. This trend will likely continue.

The NBU approach to appreciation was appropriate

The steep shift in the exchange rate gave rise to many critical comments. While the overall move towards appreciation is appropriate, a steep shift in the exchange rate could lead to substantial losses and general destabilization. Because Ukrainians are actually acclimatized to times of relatively high inflation accompanied by a stable nominal exchange rate does not mean that this is normal, let alone the only possible alternative, in the global economy. Over the last two years, the National Bank kept sacrificing internal hryvnia stability for the sake of external stability.

However, it should be pointed out that the recent change was actually not that dramatic—only 5%. Historically, in the majority of cases where there has been a successful attack by forex speculators, the exchange rate shifted much more. When financier George Soros attacked the pound sterling on 16 September 1992, the total depreciation was 12%. In Mexico, the peso fell 36% in December 1994. The daily fluctuation of the EUR/USD exchange rate has been as much as 1.5%.

The question is, could the NBU have introduced a more gradual appreciation of the hryvnia and what might the impact have been? The 2005 State Budget Law stipulates that the UAH/USD exchange rate should stand at UAH 5.10/USD 1 by year-end. The law sets no exchange rate corridor for the middle of the year.

To let the hryvnia appreciate gradually and steadily throughout the year is not appropriate to the real situation. Firstly, Ukrainian exports and imports, as well as other factors affecting forex demand and supply, have significant seasonal fluctuations. The first half of the year generally sees foreign currency inflows, while in fall forex demand often grows and supply declines. Making the hryvnia weak in spring and strong in fall will likely lead to even greater volatility on the market. Furthermore, when the exchange rate changes are set in advance, it becomes possible to make money just by purchasing the currency that is about to be changed at the beginning of the period and selling it at the end of the period, earning a profit on the difference. This creates even greater demand/supply fluctuations. In this instance, the role of the central bank, whom the Budget law rather than market mechanisms dictate the rules for setting the exchange rate, is completely neutralized.

An accelerated but not immediate appreciation of the hryvnia in about 30 days is acceptable as well. If the appreciation were slow, but real, it would have led to an even more significant rush on the forex market. If everybody can see that the NBU is appreciating the hryvnia exchange rate by 0.5 kopiyka per day over the course of a week, many banks will try to temporarily convert dollars into hryvnia. As in the previous case, this will considerably increase fluctuations on the forex market and, once again, make it possible to profit without any risk at the expense of the central bank, which will sell dollars high and buy low.

Thus, only an immediate appreciation of the hryvnia makes it possible to reduce the foreign trade imbalance without unbalancing the forex market. The fact that a minimum number of people knew about this scheduled appreciation is not to a mistake on the part of the central bank, but to its credit. When there is a chance to earn 2.7% just by selling and buying foreign currency during a single day, there is a great temptation to sell this information. So the main way to fight corruption is to simply avoid creating opportunities or conditions for corrupt actions.

The hryvnia should continue to grow stronger

Despite the stabilization of the hryvnia and assurances from the Government and the NBU that they will maintain the exchange rate at UAH 5.05/USD 1, it is very likely that the hryvnia will appreciate further in June–July 2005. Meanwhile, trade volumes on the Ukrainian Interbank Currency Exchange (UICE) remained nearly flat after 20 April 2005, when the hryvnia appreciated, although they are still 50% higher than during the same period of 2004. This trend continued until late May. In part, this was due to a certain inertia in the economy and the fact that it is impossible to radically change the flow of foreign trade. However, both NBU specialists and western experts are convinced that real appreciation will continue. Further nominal appreciation, albeit not as high as in April, is also possible. ■

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Tax reform took Slovakia from basket case to European model

The most obvious outcome of Slovak tax reform is the country's increased attractiveness to foreign investors. The year after these reforms, FDI grew 47%, while the number of new jobs created by such investments jumped by 69%. Investors choose Slovakia because of its favorable business environment and tax system, developed infrastructure, cheap and skilled workforce, and generous state assistance. The transfer of Slovak economic reform know-how to Ukraine is the subject of a new publication currently available through ICPS free of charge

In autumn 2002, a new centre-right government came to power in Slovakia. At that time, the tax system was generally considered unsustainable, overly convoluted and changeable, with ever more exemptions and special rates that distorted the business environment. Tax reform became one of the most important initiatives of the new government. The Policy Statement of this new government undertook only to "reduce income tax rates and to analyze the possibility of introducing a flat tax." In fact, the reform undertaken by Finance Minister Ivan Miklos not only introduced a now-famous flat tax, but actually went far beyond the original objectives.

The new tax system came into effect in January 2004. The goal was to create a simple, fair and business-friendly system. This as achieved by:

1. Shifting the tax burden from direct to indirect taxes, that is, taxing consumption rather than production. This is expected to provide more incentive to work. Moreover, in an era of globalization and increasing labor mobility, the collection of direct taxes becomes more difficult to control. Compared to indirect taxes, it is easier for taxpayers to evade direct ones. As a result, the relatively high direct taxes were harming the country's fiscal position and competitiveness: people were fleeing to the shadow economy or to countries with lower direct taxes. The shift towards indirect taxes is expected to greatly reduce tax evasion. The anticipated negative impact of higher indirect taxes on price levels and household consumption costs proved unfounded. Household consumption grew a strong 3.5% in 2004 compared to the 2.0% economists had expected.

2. Eliminating all exceptions, exemptions and special regimes. Business survey after business survey quoted the country's excessively complicated tax system and its frequent changes as one of the key barriers to business. The old system included 90 exceptions, 19 sources of untaxed income, 66 tax-exempt items, and 37 items with individualized tax rates. Reform virtually abolished all of these, making the Slovak tax system much simpler and transparent. It eliminated the many opportunities to fiddle accounting in order to pay lower tax rates.

3. Introducing a flat tax on personal income. Unlike progressive taxes, a flat tax on personal income does not restrict economic incentives. As the new system encourages greater effort regardless of income level, it is expected to increase productivity.

4. Eliminating tax instruments used for non-fiscal purposes. Many such instruments are intended to fulfill social policy objectives. However, taxes generally address everybody and not only those in need. Thus, they have little to do with collective responsibility. Reform in Slovakia was intended to clearly distinguishing social responsibility by replacing virtually all such instruments with targeted assistance. Tax reform was accompanied by welfare reform aimed at: (1) curbing abuse of social benefits; (2) carefully targeting social assistance to those really in need; and (3) maintaining incentives to work.

5. Eliminating double taxation of income. To assure that taxes were fair and simple, the Slovak Finance Ministry decided to tax all types and amounts of income equally. In looking for the optimal rate, the government decided to apply the same 19% rate to personal income tax, corporate income tax, and value-added tax (VAT). ■

Peter Golias, Institute for Economic and Social Reforms and *Robert Kicina,* Business Alliance of Slovakia.

More information on tax reform in Slovakia, as well as on reforms to the country's pension and social security systems, healthcare, business environment, and public administration, can be found in a new publication called "Recent Economic Reform Experience from Central Europe: Inspirations and suggestions for Ukraine." The publication was released as part of a joint project implemented by ICPS and INEKO to transfer Visegrad Group reform know-how to Ukraine. Financing was provided by the Slovak Development Agency (SlovakAid), PosAm and IPEC.

An electronic copy of this publication can be found in the ICPS internet library at http://www.icps.kiev.ua/eng/library.html?1. Printed copies can be delivered to any address in Ukraine. To get a copy, send an A4 envelope with your return address and postal stamps worth UAH 1.20 to Svitlana Borenko at vul. Pymonenka 13A, Kyiv, Ukraine 04050 (ICPS) before 15 June 2005.

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